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SUBPRIME LENDING FALLOUT: ARE REAL ESTATE AGENTS THE INEVITABLE NEXT TARGET?

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Most experts believe it is only a matter of time before real estate agents are swept into the legal maelstrom of the ever-expanding criminal investigations and civil lawsuits propelled by the subprime lending scandals. The internet blogsphere, which often proves a precursor for mainstream America, is already calling for the real estate industry's head.

Why should PLUS members care? Because many industry experts are predicting the market will experience a crush of civil lawsuits in the next 18 to 24 months filed by buyers against the one person they will claim they trusted most in the process – the buyer's real estate agent.

Subprime loans exploded during the real estate boom years as real estate agents and others preached the industry mantra: "buy as much home as you can qualify for." Subprime loans generally refer to home loans made available to potential homebuyers who would not otherwise qualify for conventional home loans.

These buyers usually are burdened with low credit scores caused by prior bankruptcies, delinquencies, or charge-offs. Subprime lending also generally involves loose lending requirements where it was possible to close a home loan with a minimal or no down payment on "stated income."

To offset the obvious risk, mortgage lenders typically charge substantially higher interest rates, fees, and pre-payment penalties. A common subprime loan is called a 2/28 "exploding" adjustable rate mortgage loan. This loan typically starts off with an affordable "teaser" rate for two years, but the interest rate "explodes" in the third year. The significantly higher interest rate frequently causes mortgage payments to balloon by more than 30 percent.

Home buyers often were induced into entering into these 2/28 loans and other high-risk deals because some real estate agents and mortgage brokers help convince buyers that their loans could be refinanced after two years as their credit scores improved and they built equity in their homes.

Unfortunately, some buyers fail to stay current on their mortgages, credit cards, and other financial obligations. Others whose credit scores improve discover that changed market conditions reduce or eliminate any equity in their homes, making refinance impossible. As least one New York state court has referred to these types of 2/28 loans as the definition of "predatory lending."

Because the number of 2/28 loans peaked during 2006, industry experts are bracing for a huge number of these 2/28 loans to default during 2008. In California alone, lending institutions sent homeowners in the state 81,550 default notices during the last quarter of 2007, which was up by 12.4 percent from 72,571 the previous quarter, and up 114.6 percent from 37,994 for fourth-quarter 2006, according to DataQuick Information Systems, an industry leader in monitoring real estate activity. Many other states reflect similar increases; although California is often considered "ground zero" in the subprime lending scandal.

By comparison, a total of 25,585 new and resale houses and condos were sold statewide last month, according to DataQuick. That's virtually unchanged from 25,578 for November, and down 41.1 percent from 43,431 for November 2006. Last month's sales made for the slowest December in DataQuick's records, which go back to 1988. On a year-over-year basis, sales have declined the last 27 months, according to DataQuick's reports.

PLUS's own blog has begun to track the "Subprime Fallout" with regular posts. To date, the subprime lending scandal has been largely confined to federal investigations focusing on the directors and officers at large mortgage lending institutions and Wall Street

insiders. Recently, we have seen these investigations pursue their ordinary timeline and expand to the large accounting firms representing these institutions.

As defaults escalate, however, it is inevitable that a wave of civil lawsuits brought by buyers seeking to shift liability to everyone involved in the transaction will follow. Plaintiffs' attorneys will seek to impose liability directly on their clients' real estate agents under a host of legal theories, including breach of fiduciary duty, failure to warn, misrepresentation, conspiracy, and fraud.

Unfortunately, the full extent of potential legal liability, if any, for real estate professionals arising out of these subprime transactions is largely untested. Most "buyer's agent" cases until now have dealt with a buyer's agent's duty to the client to inspect property or disclose known defects. In fact, a WESTLAW "all states" search of "subprime loan" fails to return a single opinion involving a subprime loan transaction where a real estate agent was sued.

That has not stopped industry experts, who already have begun to ask the question: "Where were the realtors?" Alan Studer, a professor of legal studies and business ethics at the Wharton School of Business at the University of Pennsylvania, argues in the October 2007 issue of *Knowledge@Wharton*: "It's wrong to exploit the vulnerable, and that's what goes on when you stick somebody with one of these loans. If the law is behind in recognizing this, then it's time for the law to change."

The current legal duty a real estate agent owes to his client varies from state to state, but the majority of states recognize that at minimum a fiduciary relationship exists between a real estate agent and the client. As such, the real estate agent's primary duty is to represent the interests of the client. The agent's position, in this respect, should be clear to all parties concerned in the transaction.

The agent must be faithful and observant to the trust the client places in the agent. The agent must also be scrupulous and meticulous in performing the agent's functions while never placing the real estate agent's personal interest above the client's interest. The real estate agent also must keep his client informed of all significant information applicable to the transaction.

Historically, a real estate agent represented only the seller in a real estate transaction. As a result, a seller's agent arguably would owe no duty to a buyer involved in a subprime loan. Relatively new legislation enacted in some states in the last dozen years, however, permits agents to also represent buyers. A small percentage of real estate agents have carved out a niche market as Exclusive Buyers Agents (EBAs).

As a result, the potential legal exposure for real estate agents largely depends on who the agent represented in the subprime transaction. Many of the old legal theories that apply to real estate agents have not been fully tested.

Opponents to imposing liability on real estate agents for subprime lending transactions argue that where the agent represents the seller, the agent's fiduciary duties and duties of loyalty owed to the seller-client precludes warning the buyer about the dangers or unreasonable risks of a subprime loan.

Opponents argue that where the real estate agent represents the buyer, no duty should be imposed on an agent to offer advice to a buyer in any field where he is not an expert such as mortgage lending practices. This argument, of course, belies the fact that buyers routinely rely on their agents for advice in all aspects of the real estate transaction where the agent is not an expert. Moreover, real estate agents, who are paid only when a deal closes, sometimes make ill-advised representations in numerous aspects of the transaction, including construction issues, appraisals, interest rates, future market value, and of course, the industry mantra "buy all the house you can qualify for" in an effort to close the biggest deal and earn the highest commission possible.

Real estate agents also routinely refer buyers to mortgage brokers and lending institutions. In fact, some agents maintain exclusive referral agreements with mortgage brokers and lenders. Where the referral was part of an ordinary course of business, the question arises whether a real estate agent owes his client a duty to investigate whether a mortgage broker is competent. A real estate agent who makes such a referral may also owe a duty to disclose to a client-buyer that the mortgage broker or lender is writing subprime loans that are defaulting at an unreasonable rate or is facing numerous complaints about other shady practices if the agent possesses such information.

The potential legal liability of real estate agents is complicated further because most states maintain their own codes of professional ethics for real estate agents. National Community Reinvestment Coalition Executive Vice President David Berenbaum points out in the *Knowledge@Wharton* article that the National Association of Realtor's code of ethics requires a realtor to "treat all parties honestly" and "protect and promote the interests of their client" which leaves plenty of room for a realtor to "raise a red flag over a hazardous loan."

How the courts ultimately decide the legal liability for real estate agents caught up in the subprime lending mess is yet to be seen. Nevertheless, some real estate professionals see opportunity beckoning rather than more risk. These bold souls are now positioning themselves to venture into the specialized market of handling the inevitable foreclosure-related residential real estate transactions that will explode across the country in 2008.

Foreclosure is the legal process where the mortgage lender, or current owner of the mortgage, seeks to seize and sell the property because a borrower is in default on the loan. The inevitable explosion of foreclosure sales in the next few months presents a unique opportunity for real estate agents in an otherwise shrinking traditional market. The

foreclosure market, however, is a potential legal minefield for an inexperienced agent.

For example, the Home Equity Sales Contracts Act of 1979 governs the sale of some foreclosures in California. The HESCA applies where (1) the property is a one-to-four family dwelling; (2) the owner occupies the home as a principle residence; (3) an outstanding notice of default is recorded; and (4) the buyer will not occupy the residence as his primary residence.

Where these requirements are met, a real estate agent cannot represent a buyer in such a transaction. If the real estate agent fails to insure that all legal requirements of the HESCA are met, a seller conceivably can cancel the sale up to two years later and recover the property from the buyer. The seller can also sue the real estate agent in civil court where the act permits recovery of actual damages, treble damages, attorney's fees, and costs.

In Texas, the courts have not clearly established a real estate agent's legal liability for failure to insure that proper notice is given to a third party who possesses a legal or equitable interest in a property affected by foreclosures. The third party has standing to challenge the sale of the foreclosure to the extent that the sale will affect that third party's legal rights, including the right to rescind the sale and recover the property.

In some states, special rules govern the listing of homes for a "short sale." A short sale is a transaction where the seller's lending institution will accept less than the payoff of the loan. As the number of subprime loans in default escalates and the overall real estate market stays soft, industry experts expect the number of short sales to increase dramatically.

A short sale also involves numerous credit and tax issues for the seller. A real estate agent could insist in writing that a seller facing a short sale consult with a tax attorney or accountant to resolve any such issues prior to listing the property for sale. It is possible that the disadvantages of a short sale may so outweigh the advantages that it is better to seek another resolution.

No one knows the full impact of the subprime fallout. No market data is readily available for the number of professional liability policies written for real estate agents who regularly represented buyers in subprime transactions or who regularly list foreclosures. What is certain is that the professional liability underwriting market must prepare now for the inevitable claims because the risk is upon us.

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